CASH FLOW RATIOS FOR EVALUATING FINANCIAL PERFORMANCE: A CASE STUDY OF LISTED MANUFACTURING COMPANY IN SRI LANKA

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Abstract

With the financial analysis of an entity, the cash flow statement may be more reliable than balance sheet and income statement information as because balance sheet and income statement information as because balance sheet information static and the income statement contains many non-cash transactions. The cash flow statement, however, is dynamic. It records the changes in the other statements over a period of time and focuses on the cash available for operations and investments. Traditional ratios have both positive and negative impact on the performance of an entity. When traditional ratios (current and quick ratios) are positive, profits may be increased. While at the same time, an entity may be in severe financial distress due to the inadequacy of cash. Against this backdrop, this paper sheds light on the importance and application of different types of cash flow ratios for evaluating financial performance. This study also made an attempt to predict financial health of the selected company. ABANS Listed manufacturing, through cash flow ratios for the period 2003-2007. It is found that the sample company has a very good financial flexibility with quality earnings and positive trends in scheduling its capital expenditure. The study reveals that the sample enterprise is not carrying a god liquidity position as well as it has shown a poor efficiency is not carrying a good liguidity position as well as it has shown a poor

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1.0 Introduction

With the introduction of the SFAS-95, United States of America, cash flow statement became an integral part of the financial statements. Now, in all over the world, cash flow statement becomes a popular item for financial reporting. In Sri Lanka, all respective companies are now preparing the cash flow statement for financial reporting in accordance with the requirements of the Accounting standard: International Accounting Standard (IAS)-7 as adopted by Sri Lanka Accounting Standards (SLAS).

Ratios derived from the cash flow statement have the potentiality to increase the usefulness of cash flow statement and other financial statements used in financial reporting. The Financial Accounting Standard Board (FASB) suggest this statement be used by investors, creditors, and others to assess: (i) an enterprise's ability to generate future positive net cash flows, (ii) an enterprise's ability to meet its obligation and pay dividend and its need for external financing, (iii) the reasons for differences between net income and associated cash receipts and payments and (iv) the effect of an enterprise's financial position of both its cash and non-cash investing and financing transactions during the period (Carslaw & Mills,1991). Cashflow ratios can especially be used as a liquidity measure to predict financial failure and ultimate bankruptcy. Cash flow information can give a better indication of the liquidity of an entity because nothing is more liquid than cash.

Traditionally, however, ratios are used for financial analysis. These ratios are grouped into liquidity, assets management, debt management and profitability (Weston et al., 1993). With the inclusion of cash flow statement in financial reporting, new and useful information becomes available for financial analysis. Cash flow information derived from other sources has also been employed, for sometimes in traditional ratios constructed to predict financial variables and to evaluate performance. Many researchers (Lee, 1982; Dambolena and Shulman, 1988; Stanko and Zeller, 1993; Mills and Yamamura, 1998) emphasized the importance of inclusion of cash flow ratios that are derived from the cash flow statement in financial analysis. A set of cash flow ratios can be used in conjunction with the traditional balance sheet and income statement ratios that could be of more value to determine the financial strengths and weaknesses of an entity (Carslaw and Mills, 1991).

2.0 Theoretical Discussion of Cash Flow Ratio

In order to analyze financial statements effectively, a set of cash flow ratios must be developed using information obtained from the cash flow statement. Many new cash flow ratios are discussed in recent business literature or used in financial statements in countries where the cash flow statement is mandatory. However, till to date, there is no consensus on a comprehensive set of cash flow ratios for the evaluation of the enterprises financial performance different users may employ different financial ratios even when used for the same purpose. The cash flow ratios, which had hitherto been developed were discussed in the study of Beaver (1966), Giacomino and Mielke (1988, 1993), Carslaw and Mills (1991), Figlewicz and Zeller (1991), Zeller and Stanko (1994), Rujoub et al (1995), and Mills and Yamamura (1998). In this section, we mention the cash flow ratios that can be used for measuring quality of earnings, financing policy, liguidity, solvency and financial health, efficiency and capital expenditure of an enterprise. The explanation of each ratio is given along with the discussion of results.

Table-1: Cash Flow Ratios

Cash flow Ratios	Meaning	Title of Ratios	Calculations
Measuring of Quality of Earnings	It measure the quality of earnings of an organization in terms of the capacity of generating enough cash as measured by cash flow from operations (CFFO) to support current level of operations as well as to generate future earnings.	Operating Fund Index Ratio	Net Income / CFFO
		Reinvestment Ratio	Capital Investment / Depreciation + Sales of assets
		Cash Flow Adequacy Ratio	CFFO / (Capital Investment + Inventory addition +Dividend + Debt Uses)
		Depreciation – Amortization	Depreciation + Amortization

		Impact Ratio	CFFO
Measuring Financing Policy	It clarifies the firm's financing policy. Financial policy reflects the decisions of a financial manager in financing an organization's assets for operations and growth.	Cash Sources Component Percentages Ratios	Individual sources / Total sources
		External Financing Index Ratio	CFFO / External financing
		Cash Productivity Ratio	CFFO / Capital Investment
Measuring Liquidity	Cash flow information is more reliable than balance sheet or income statement information when it comes to liquidity analysis. Those ratios provide more information about a company's ability to meet its payment commitments than traditional balance sheet's working capital ratios.	Operating Cash Flow Ratio	CFFO / Current Liabilities
		Cash Current Debt Coverage Ratio	Current Debt / CFFO – Cash dividend
Measuring Solvency and Financial Health	Solvency and financial health ratios show the compatibility of an entity in carrying debt, the ability to pay return to the funds provider. In the long run, a firm should produce sufficient cash from operations to meet its commitments. For the long-term	Long Term Debt Repayment Ratio	Total long term debt / CFFO
		Cash Interest Coverage Ratio	(CFFO+Interest paid+taxpaid) / Interest Payment
		Mandatory Fund Flow Ratio	(Funds for operations +Fund applied to long term debt) / Total sources of fund
		Discretionary Fund Flow Ratio	Discretionary fund uses

	sustainability, a firm should have sources of cash exceeding it uses.		Total sources of fund
		Cash Uses Component Percentages Ratio	$\frac{\text{Individual uses}}{\text{Total uses of cash}}$
Measuring Efficiency	Efficiency ratios measure the cash generating efficiency of an enterprise from its sales as well as from investments. .	Cash Flow to Sales Ratio	$\frac{\text{CFFO}}{\text{Sales}}$
		Cash flow to Assets Ratio	$\frac{\text{CFFO}}{\text{Assets}}$
Measuring Capital Expenditure	Capital expenditure ratios measure whether a company's cash-generating ability is capable of financing capital expenditure along with its obligations.	Capital Acquisition Ratio	$\frac{\text{CFFO– Total dividend}}{\text{Cash paid for acquisition}}$
		Investment/ Finance Ratio	$\frac{\text{Net cash flows from investing}}{\text{Net Cash flow financing}}$

3.0 Objectives

In the light of the above discussions the study is designed inter alia to attain the following objectives.

1. To focus the importance of using cash flow information in evaluating financial performance of an entity.
2. To assess the financial performance of ABNS company
3. To suggest the measures for its improvement.

4.0 Material and Methods

This section describes the scope, data sources, study period, reliability and validity and mode of analysis.

4.1 Scope

In the light of the objectives of the study, it is necessary to choose an enterprise, which prepares cash flow statement for its financial reporting purpose.

4.2 Data Source

The study is an empirical one. The existing available textbooks, related journals, bulletin, magazines and research works have seen gone through to prepare the theoretical framework of the study. The study is mainly based on the secondary data. The sources of data used in the study are

4.3 Study Period

The study covers a period of 05 years from 2003-2007. Due time and financial constraints of the researchers, the present study has covered the period of immediate past years.

4.4 Reliability and Validity

Secondary data for the study were drawn from audited accounts (i.e., income statement and balance sheet) of the concerned companies as fairly accurate and reliable. Therefore, these data may be considered reliable for the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence, researchers satisfied content validity.

Mode of Analysis

Collected data have been tabulated and analyzed by various mathematical and statistical methods to make the study more informative.

Results and Discussions